Testimony of
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Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present the views of the Federal Deposit Insurance Corporation (FDIC) on technological change and the future of the financial services industry. As you know, the financial services marketplace is changing rapidly and will continue to do so for the foreseeable future. The financial services industry of tomorrow will probably be much different from the industry of today. Now is the time to begin considering what we must do to prepare for the changes we face, and we appreciate your providing a forum for discussing these issues.

There are several related trends shaping the financial services industry - consolidation, blending of financial services and increased competition between banks and other financial service providers, globalization, innovative financial products, and new delivery channels. Technological change is a key driver of these trends along with the interplay between market forces and government involvement. The trends underway are likely to lead to significant changes in how households and businesses choose to hold assets, make payments, and finance their needs and opportunities. To be successful a decade or two from now, financial firms will need to constantly monitor changes in the marketplace and evaluate strategies that deal with an evolving financial and technological environment.

I will cover these trends in turn and then discuss the challenges policymakers and regulators face in their efforts to further financial stability while allowing the industry to evolve in response to changes in the market and in technology.

MAJOR TRENDS

Consolidation

From 1990 to 1998, the number of FDIC-insured institutions in the United States declined from 15,796 to 10,461. Although bank and thrift failures contributed to this shrinkage, failures accounted for only 907 banks and thrifts out of the 5,335 institutions

that left the industry during this period. Although the remaining shrinkage has resulted primarily from holding companies consolidating their operations, it also represents a long-term industry consolidation trend that has seen institutions merge and be acquired.

This trend is the result of several factors. One is the relaxation of interstate branching restrictions, particularly the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Relaxing these restrictions made acquisition a faster route to geographic expansion than internal growth. This is evident in the data which show that, despite the decline in the number of institutions, the number of offices remained relatively unchanged during this period, indicating consolidation rather than outright closings. Another factor is the availability of capital. The 1990s have seen banks and thrifts build their capital ratios to the highest levels in more than 50 years as a result of a recovered and healthy economy and the resulting strong earnings of the industry. Many institutions have used their capital to fund acquisitions, contributing to the ongoing consolidation in the banking and thrift industries. The long-existing economic pressures on banking organizations to grow and to cross state lines, coupled with the removal of legal barriers based on geography, are likely to continue for the foreseeable future, and the number of banking organizations likely will continue to decline for some time. Although these economic and regulatory factors are important, improvements in technology have provided the means to manage the geographically dispersed financial businesses that consolidation has created.

From the perspective of the regulatory community and the FDIC, an important result of this period of consolidation has been the growing concentration of assets and insured deposits in the country's largest institutions. These so-called "megabanks," frequently themselves the product of mergers between already-sizeable institutions, command an increasing presence in the U.S. economy. While 41 banking companies held 25 percent of total domestic deposits in 1984, it took only 11 companies to account for the 25 percent share by the end of 1997. Now, after the large mergers announced in 1998, just 7 banking companies hold 25 percent of domestic deposits.

Consolidation of banks serving different markets can diversify risk and decrease earnings volatility, thereby decreasing the likelihood of failure. Regional recessions and sectoral downturns contributed to many of the bank and thrift failures in the late 1980s and early 1990s. Many of the institutions that failed or were troubled tended to have either geographic or product concentrations. Broader diversification of risks through mergers of institutions serving different markets can moderate the effect of economic downturns on these institutions.

Consolidation in the banking industry also poses some risks for the FDIC as the deposit insurer. The deposit insurance funds face larger potential losses from the failure of a single large consolidated institution. Insurance is based on the concept of diversifying risk and, as the industry becomes more concentrated, the FDIC's risk becomes less diversified. Larger institutions also are more complex and tend to be involved in more non-traditional activities. Very large banks also pose challenges when they are in danger of failing, both because of systemic concerns and because of the operational

difficulty that the FDIC would face in resolving them. We will discuss how we are meeting these challenges later in our testimony.

Increasing Competition Among Financial Service Providers

To a greater extent than ever before, businesses have replaced bank financing with capital-market financing. Businesses increasingly are able to meet their funding needs by issuing commercial paper, debt securities and equity, rather than by borrowing from banks. In addition, banks and thrifts are experiencing increasing competition from nonbanking firms that now offer financial products that once were the exclusive domain of banks and thrifts. Money market funds, which are functionally similar to deposits, are but one example. Banks, in turn, have begun offering products like annuities, mutual funds, insurance products, and securities that were once the province of other providers of financial services. The result has been an increasingly blurred distinction between previously well-defined segments of the financial services industry. These developments, of course, are driving the repeated attempts to modernize the financial system and proposed legislation to repeal key Glass-Steagall restrictions and allow banks to affiliate with companies that engage in a wider range of securities and insurance activities. Meanwhile, the marketplace continues to evolve, producing an increasing variety of financial conglomerates.

The FDIC believes that financial modernization is not only desirable, but necessary, to enable the financial services industry to meet the challenges that lie ahead. The existing regulatory system has worked well in an environment of relatively well-defined distinctions between banking, securities, and insurance products. The FDIC recognizes, however, that new financial combinations bring new problems to prudential supervisors and to assessment of the risk facing the deposits that we insure. Supervision of financial conglomerates will require that banking regulators ensure that the capital of insured banks and thrifts is not impaired or diluted through inter-affiliate relationships.

Just as the boundaries between banks and nonbanks are eroding, so are the distinctions between banks and thrifts. In the 1930s, there were substantial differences between commercial banks and S&Ls. In general, S&Ls were mutual institutions that primarily offered savings accounts and home mortgages for consumers. Because their charters permitted limited activities, they were not allowed to offer checking accounts, consumer loans, or commercial loans. Indeed, their loans were virtually all long-term, fixed-rate residential mortgages. Commercial banks, on the other hand, served mostly commercial customers. More than two-thirds of bank deposits were demand deposits and banks made very few residential mortgages. Over time, the distinctions between banks and thrifts have become blurred. Each has entered what was once the other's domain. Both offer essentially an identical array of deposit accounts.

Not only have the banking and thrift industries become more similar over time, but the composition of who holds SAIF-insured deposits has changed as well. The name Savings Association Insurance Fund connotes a fund that insures savings associations. When it was established, this was indeed the case. Virtually all SAIF-insured deposits

were held by SAIF-member thrifts. However, over the last decade, this has changed dramatically. As of September 30, 1998, commercial banks (35.1 percent) and BIF-member savings banks (8.1 percent) held over 40 percent of all deposits insured by the SAIF. Indeed, two of the five largest holders of SAIF-insured deposits are First Union National Bank and NationsBank N.A. The name Savings Association Insurance Fund has become a misnomer. The SAIF has become a true hybrid fund.

Globalization

A major characteristic of the post-war era has been the increasingly global reach of commerce, a trend that has left few industries unaffected. While the largest financial institutions were actively and enthusiastically involved in shaping this trend, smaller financial institutions and their customers often appeared insulated from it. More recently, however, events have illustrated that this insulation, even if it did once exist, no longer does. This trend toward global awareness and activity has been accelerated by the rapidly increasing power and accessibility of information technology -- technology that has the potential to link every home and business around the networked world.

These expanding cross-border linkages between and across industries, markets and individuals have driven banks to keep pace, and banks have done so successfully to a degree that challenges both the financial infrastructure and those who regulate it. The seriousness of this challenge was highlighted last fall during the Russian debt default and the near-collapse of Long Term Capital Management LP. By many measures, the challenge continues to grow. Because potential systemic threats can now arise in so many places, they are difficult to predict and to evaluate.

One measure of the degree to which financial institutions are integrated into this global infrastructure -- and the degree to which their exposure is growing -- is their foreign exchange activity, which the Bank for International Settlements has placed at close to $1.5 trillion per day globally. U.S. financial institutions represent approximately $350 billion of this total, an amount that reflects a doubling of their exposure since 1989. From this measure at least, it is clear that international linkages and their corresponding benefits and risks are increasing.

Offsetting some of the risk of an increasingly interconnected financial world is the similarly increasing scale of cross-border cooperation between financial industry supervisors and between the market participants they regulate. Through its constituent central banks, the Bank for International Settlements seeks to harmonize regulatory capital requirements across countries and to outline core principles that can be used by regulators in all countries to diminish the level of risk in their banking systems. On the private sector side, a number of global banks are dedicated to developing a default-free cross-border settlement system. The FDIC encourages and contributes to such efforts to reduce the systemic risk potential in the global financial system.

To address the influx of foreign banking organizations into the United States and the expansion by U.S. banks into foreign markets, U.S. and global bank supervisors are

also involved in programs aimed at coordinating, cooperating and sharing information. Federal banking agencies have entered into information-sharing agreements with each other and with foreign supervisors. The Department of the Treasury and the U.S. regulatory agencies, including the FDIC, participate in many important supervisory initiatives, including training programs for bank supervisors in foreign countries and interagency groups that study such topics as impediments to information sharing among foreign bank supervisors. Initiatives also address global financial stability issues, technological developments, and legal issues that arise in international banking supervision. In addition, the Basle Committee on Banking Supervision brings together banking supervisors from around the world to discuss common approaches to bank supervision.

Financial Innovation

One major result of consolidation and globalization is that the geographic exposure of many banks is considerably more complex than before. While greater geographic exposure can diversify risk, and thereby reduce it, the credit and counterparty risks facing financial institutions have grown considerably more complex and harder to evaluate. In addressing some of the risks of this complexity, banks have turned to the use of financial instruments that can reshape their risk profiles.

The creation and spread of more sophisticated financial instruments has been a key trend in financial innovation. The availability of these instruments is challenging how financial institutions and their regulators worldwide think about risk. One product of this trend is securitization, a process where the cash flow from a pool of assets is divided and resold as separate securities. Another is a class of instruments commonly known as derivatives, which generate obligations between the buyer and seller based upon the value of some asset that neither necessarily owns.

Most categories of major bank credit products, including credit card receivables, car loans, home equity loans, small business loans and commercial real estate loans, have been securitized in one form or another. Similarly, the flexibility afforded by financial derivatives in tailoring cash flows accounts for the growth in these products that we have witnessed on - and off - bank balance sheets. Between 1990 and 1998, the notional amount of derivative contracts in the portfolios of insured commercial banks increased from $6.7 trillion to $32.9 trillion. The number of fertile areas for which their use is now being suggested -- areas such as managing credit and real estate exposures -- suggests that trend will continue into the foreseeable future.

Developments such as these are challenging regulators' ability to monitor and assess risks in insured institutions. Consequently, they have implications for the FDIC's insurance and supervisory functions that I will discuss later in this testimony.

Risk Management and Risk Models

The techniques that have made financial innovation possible have also been applied in assisting financial institutions to quantify and manage their risks. Value-at-risk models are one result of these innovations. Credit risk models are another. Both are finding increasing use in financial institutions and are being reviewed by regulators for their usefulness in avoiding or limiting losses. Technology has made much of this computationally-intensive work possible and offers the promise that yet greater amounts of data - and models that employ them - will soon be available to assist financial institutions of all sizes to control their exposures. The use of sophisticated analytics is a key tool for banks in understanding the increasingly complex financial environment.

Of course, the use of such models should be accompanied by thorough and ongoing evaluation. Although technologically sophisticated and statistically supportable, risk management of this sort carries the risk of designing a model incorrectly. Models frequently draw from past relationships between the data to project the likelihood of future events. If these relationships change fundamentally, the model may not predict well. In addition, because it is difficult to know the likelihood of rare and extreme events, it is difficult to model such events - a difficulty illustrated last fall by Long Term Capital Management LP. Unfortunately, such events are particularly important, since they may have systemic repercussions.

Managing risk well is not entirely a matter of models, however. The importance of adopting a risk management culture that overlays all of an institution's functions has gained increasing recognition. One product of this increasingly risk-oriented mindset has been the identification and implementation of best practices. These practices, which include the integration of management at all levels into the development of risk control policies and contingency plans, are important for all institutions regardless of their technology skills or budgets.

Payments and Product Delivery Technology

Another major trend in the financial services industry has been the application of telecommunications and information technology to the delivery of bank products and services. As computers have begun to replace bank tellers as the interface between bank and customer, so, too, has a notion of vulnerability begun to replace that of security in the minds of many bankers with respect to both their traditional lines of business and the security of their computer systems. Simply put, new developments in technology can open new opportunities for banks to expand their services but will also bring competition and new sources of risk.

The growing adoption of the Internet for all forms of commerce will strengthen this trend. Customers can increasingly engage in most of their banking transactions at their own computers. Enhancements to remote services now include the transfer of cash balances to customer stored value cards and bill payment directly from customer accounts to those of their creditors and vendors. While these services represent a logical extension of existing bank businesses, they are also logical extensions of the businesses of their nonbank competitors. Securities firms and insurance companies that

are already well placed in the virtual world might find the leap to banking services less intimidating than in a world that required brick and mortar. So too could technology companies that specialize in electronic commerce find their cost advantage useful in disintermediating banks from bill presentment or retail payment services, thereby threatening banks' customer relationships. And if these technologies have opened the door to penetration of bank market share by non-bank competitors, they have also increased the potential for illicit penetration of bank systems and the compromise of confidential bank databases.

Securing electronic commerce and the security of bank information are major drivers of the trend toward application of technology to bank products and services. For the regulatory community, the challenge lies not only with the risks associated with the banks' use of these new channels, but also with the structural changes that they might bring to the financial services industry. To the extent that regulated depository institutions are displaced from their core businesses, activity that was once in the domain of the regulatory community may evolve to less-regulated or unregulated participants.

Where could these trends lead?

While speculating on the shape of the financial services landscape decades into the future is a challenging exercise, it is one that can help focus our attention on the long-term issues we need to begin addressing now.

Current consolidation trends suggest that the industry in the future may be bifurcated - that is, there could be a number of very large institutions and a much larger number of very small ones. The largest institutions could appear much as they do now, with increasingly broad product mixes, funding sources, and extensive cross border and cross-industry affiliations and activities. What could vary considerably from the present, however, is the greater size and breadth of these institutions, a possibility suggested by recent mergers that have seen the creation of cross-border and cross-product financial service firms. What could also vary is the considerably greater degree to which they can extend their reach beyond their physical branches, an extension made directly possible by the growing public embrace of the Internet. In this global electronic world, bank trade areas may be increasingly difficult to define, and traditional methods of management and regulation will be tested.

At the other end of the barbell would be the small institutions, which could conceivably appear very different from today. There are a number of reasons to expect that these smaller banks will continue to thrive. One is that they may satisfy a particular customer need that their larger counterparts do not - needs such as more personalized service or a high level of local knowledge that the more remote large institutions do not have. Another might be that, like the large banks, they employ technology wisely to extend their reach beyond their limited physical offices. Yet another might be that small institutions act as intermediaries between their communities and much larger depository institutions or non-banks. This strategy would have them acting as brokers of financial

products and deriving their income increasingly from fees or commissions rather than spreads between their liabilities and assets. To a considerable extent, we have already seen such strategies by institutions that stress customer service, by those that invest heavily in Internet delivery channels, or by those that securitize their assets. It is therefore not unlikely that successful small institutions of the future will pursue all of these strategies to a more pronounced but still varying degree.

There are implications for risk management as well. Even among smaller banks, asset diversification need not be limited by a trade area measured with respect to their bricks and mortar. The ability to make loans over the "information superhighway" could provide even the smallest financial institutions with the ability to tailor their geographic or sectoral exposures by seeking loans in areas and industries where they are under-weighted. Alternately, it could provide a market by which small banks could buy and sell exposures to the risks they want or have in excess, in a manner similar to the reinsurance transactions that are a staple of the insurance industry today.

Making remote loans over electronic channels will complicate risk management for smaller institutions, however, because underwriting non-local customers negates the local knowledge that many of these institutions can claim as a core advantage. To address this deficiency, institutions might have to rely upon data collected and provided by third parties, either qualitatively or through scoring models. In either case, the need for such information by a large number of bank and nonbank institutions implies that market participants may demand large, centralized databases of such information. Although this is a logical step technically, it raises issues concerning the privacy and security of vast amounts of consumer and business information.

IMPLICATIONS FOR POLICYMAKERS AND REGULATORS

The trends underway pose challenges not only for managers of financial firms, but also for policymakers and regulators whose job it is to ensure that the financial system continues to contribute to economic growth and well-being. The issues involved in deciding how to regulate a financial system are complex. The first issue to deal with is what should be regulated: what firms, what products, what markets. Within the regulated sphere, the lines must be drawn between efforts designed to protect consumers, promote market integrity, protect investors, and promote the safety and soundness of institutions and the stability of the financial system. The challenge is to allow the industry to evolve in response to market, technological, and demographic developments while maintaining financial stability and public confidence.

A central issue here is the tension between market forces and government intervention. Policy and regulation tend to move at a more measured pace than market and industry developments. For the most part this is desirable, but we run the risk that the gap between the market and the regulatory environment will lead to misallocation of credit or instability. The question of how to manage this tension is present in the key features of any deposit insurance system: risk assessment, resolving problem institutions, and limiting the scope of the safety net.

I will focus the remainder of this statement on issues that are closely related to the deposit insurance system, recognizing that the Committee will hear from others who are more than able to shed light on these broader areas.

Deposit insurance is one component of the federal safety net for the banking system, along with the lender of last resort responsibility of the Federal Reserve System and the prudential supervision provided by the four federal banking agencies. Created in 1933, the FDIC experienced a relatively tranquil first fifty years. This was followed by a decade of crisis beginning in the early 1980s. The last five years have seen restoration of the insurance funds, few failures, and an extremely strong industry performance.

In recent years, there have been a number of proposals for significant reform of the deposit insurance system, including privatization. Advocates of reform typically argue one or more of the following: the regulatory burden that accompanies deposit insurance far outweighs the benefits; deposit insurance leads to a too-big-to-fail-doctrine that severely distorts the financial system; or, the present regulatory structure cannot mitigate the moral hazard problem created by deposit insurance.

The outcome of debates about these important issues will affect the evolution of the banking industry in the decades ahead. In light of this, the FDIC sponsored a conference just over a year ago to explore these issues. I will cover a few key points that we feel speak directly to the long-term vision of deposit insurance and its role in the financial system.

At the conference, two prominent advocates of privatization of deposit insurance presented their proposals. As they looked to the future, they felt that a government-administered system was incompatible with a dynamic and efficient financial system. Their view was that the regulatory and supervisory structure that accompanies federal deposit insurance could not keep pace with market developments without stifling the industry.

Several speakers at the conference argued against privatization. Many felt that without federal involvement, the public confidence necessary for a stable financial system would not be present. Related to that was the observation that during good times it is tempting to underestimate the value of a well-functioning safety net; the problems in Asia were cited to underscore this. Others pointed out that even in the absence of federal deposit insurance, federal regulation and supervision of the banking system would be necessary.

Looking a decade or two down the road, as we are being asked to do today, my sense is that the arguments supporting a federal role in providing deposit insurance that are valid today - the importance of public confidence and the reality of government oversight even in the absence of federal deposit insurance - will remain valid.

Having said that, one must recognize that the deposit insurance system must keep pace with changes in the marketplace. The concerns of the reform advocates are real. Poorly administered deposit insurance, and safety nets in general, can be extremely expensive for the banking industry and the taxpayer. Regulation and supervision designed to protect the insurance funds can go too far, preventing banks from serving the needs of consumers and businesses.

This leads to the question of how we assess whether the deposit insurance system is functioning as well as it should be and keeping pace with market developments. To a great extent, this is difficult to assess in good times. The test of the system typically comes during times of stress.

Since the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) reforms were put in place, the economy has enjoyed a long expansion. The U.S. banking industry has enjoyed seven years of record earnings. The next economic downturn in the U.S. will test the lessons learned from the last crisis and the reforms that followed. Early on, perhaps now, the test will be how effective risk-based supervision and risk-based premiums are in preventing excessive risk-taking. When problems emerge, the focus will be on the extent to which prompt corrective action prevents failures by forcing banks to restructure, restore capital, or be acquired before their value is exhausted. When failures do occur, their impact will be determined by the measures designed to limit the costs of failures: least-cost resolution, the revamped too-big-to-fail determination, and depositor preference.

Not only will the reforms of the deposit insurance system be tested by cyclical forces, but also by the secular changes underway in the financial services industry. The blurring of lines among financial products and services challenges policymakers to find the appropriate scope of the safety net. As discussed earlier, consolidation in financial services is likely to lead to an industry with relatively few large financial conglomerates and several thousand smaller traditional banks. This will raise questions about the ability, both financially and operationally, of the deposit insurance system to handle potential failures of large institutions and also will highlight issues of fairness in the government's treatment of small and large banks.

While these reforms have yet to be tested in difficult times, we expect that they will serve us well as financial modernization and consolidation of the industry proceed. The FDIC recognizes that to ensure that this is the case, we must take steps to prepare for the challenges that lie ahead. In what follows, I will discuss three areas of critical importance to the FDIC as we look ahead to the coming decades.

Supervisory Process

The supervisory process must continue to adapt to the changes underway in the industry. We must balance the need to let markets develop without undue regulatory interference while maintaining the safety and soundness of the system. Over the past decade as the industry has adopted the risk management approaches described above,

bank supervisors have moved to a more risk-focused approach. The agencies are also embarking on strategies that take advantage of technology to streamline and improve the supervisory process.

For some time, supervisory approaches have varied with the characteristics of the bank - size, complexity, business lines, etc. The Federal Reserve and the OCC maintain teams of examiners onsite in the largest institutions. Small banks are examined every twelve to eighteen months. Large banks are expected to have more sophisticated risk management practices, information systems, and internal controls. As the bifurcation of the industry proceeds, the need for different supervisory approaches to community banks and large complex institutions may grow. This will be necessary in order to keep pace with an increasingly complex industry without slowing innovation and without creating an undue regulatory burden, particularly on smaller institutions.

The FDIC currently relies to a great extent on other regulators to act as agents in monitoring the risks posed by the larger banks in the industry. We supplement these efforts through offsite monitoring. It is becoming increasingly difficult for the FDIC to fully assess its risk exposure in the largest banks. The changes underway may require the FDIC, as insurer, to bolster these efforts through more direct access to information, and greater reliance on market surveillance of these institutions.

The FDIC's role as backup supervisor has been used sparingly in the past and limited for the most part to problem institutions. As institutions grow larger and more complex, the FDIC will need to ensure that it understands the business of these banks and the risks they pose - even when problems are not apparent. This may require more direct contact with large banks for which we are not the primary federal regulator.

Whether in our role as insurer, supervisor, or receiver, the changes in the industry require us to re-examine our information needs. Currently, the FDIC relies on three primary sources of information as windows on the industry: onsite examination of state nonmember banks (including state exam reports) and, in some cases, troubled institutions whose primary federal regulator is not the FDIC; examination and inspection reports on all other insured institutions prepared by other federal regulators; and offsite analysis of financial information submitted by insured institutions.

As the industry becomes more dynamic, one concern stems from the frequency in which this information is generated. Examinations occur every 12 to 18 months, and financial information is submitted quarterly. Risks and conditions can change very rapidly, especially when dealing in complex financial instruments and markets. To do its job well, the FDIC needs to be able to monitor at frequent intervals, in some cases on a real-time basis, changes that affect institutions.

There are other forces that may necessitate new approaches to information. Nationwide banking and globalization render quarterly Call Reports less informative about exposure to national, regional and local economic conditions. Securitization and derivatives make balance sheet information a tenuous indicator of bank exposure. These information

problems need to be addressed so that the FDIC is prepared to operate effectively and efficiently in the future.

Resolving Large Complex Institutions

The potential for one or more large institutions to experience severe problems has always presented the FDIC with some of the most difficult issues it faces. These include operational, financial and policy issues: how to be ready, operationally, to resolve the problem with minimal disruption; how to ensure that our financial resources are adequate, and how to balance the need for stability against the need for long-term discipline. Although a failure of a nationwide U.S. bank with global operations and multiple non-bank affiliates and subsidiaries may never occur, the FDIC must be prepared for such an event. Issues include balancing the interests of multiple national legal systems with respect to the claims of creditors, identifying insured deposits in a timely manner, and the handling of derivatives, foreign exchange and other short term claims that may affect the smooth functioning of domestic and international payments. While it is impossible to know precisely the circumstances we will confront in the future, the complexity of the issues highlights the importance to the FDIC of contingency planning. In light of this, we have established a contingency planning group within the FDIC to consider these issues and recommend measures to ensure our preparedness.

As insurer, we want risk to be managed effectively in order to prevent problems from occurring. But problems inevitably will occur. When problems arise, the public and the industry have a right to expect the FDIC to handle them in a cost effective and non-disruptive manner.

Harnessing Market Forces to Assess Risk

As banks get larger and more complex, the case for supplementing the supervisory risk assessments with market judgments becomes more compelling. There are several avenues to explore here.

Large banks are currently subject to considerable market oversight. The majority of industry assets are in publicly traded banking organizations. One approach is to assess risk based on information the market currently provides, such as equity and debt prices. The idea is that the market requires riskier banks to pay more for capital and funding, and this provides a market view of overall trends in risks and differences in risks among banks. These market judgments could be factored into measures of insurance fund exposure and the risk-based premium system.

One market approach that has received attention over the years is to require banks to issue subordinated debt. Under some proposals, deposit insurance premiums could be tied to the rates the market requires or corrective actions could be imposed on banks that cannot roll over their subordinated debt. Under this proposal, mandatory subordinated debt can be viewed as a way to generate market signals of bank risk and to provide an additional buffer between bank losses and deposit claims.

Proposals to require subordinated debt dovetail with the ongoing discussion of capital regulation for banks. The current system relies on leverage ratios and various risk-based capital measures. The risk-based capital system was designed for internationally active banks to achieve consistency and a level playing field. The system is a decade old and the regulatory community is taking a hard look at whether the current approach can keep up with changes in the industry. The issues under discussion include whether risk-weighting assets makes sense, whether small banks and large banks should be subject to the same system, whether to rely on internal models, and the effectiveness of the pre-commitment approach.

To get a more direct measure of the risks it faces, the FDIC could enter into risk-sharing arrangements with market participants. The reinsurance study mandated by FDICIA considered one such approach. Since that time, financial innovation has produced risk-sharing instruments such as credit derivatives and insurance derivatives that may speak more directly to the task at hand. It may be possible to use such instruments to get a market perspective on the exposure of the insurance funds and the risks posed by individual banks or groups of banks. The market prices could be factored into the risk-based premium system, either directly or with some modification.

There are a number of potential advantages to a market-guided approach to deposit insurance. First, as we learned from the resolution and liquidation efforts of the past decade, well-designed and well-executed public-private partnerships can enhance the FDIC's ability to perform key parts of its mission, particularly when the tasks at hand are similar, if not identical, to tasks performed by the private sector. Assessing risk is one such task.

Second, the pace of change in financial markets may leave little alternative to a market-guided approach. As mentioned earlier, to the extent that the evolution of financial markets outstrips the evolution of the regulatory framework, the potential grows for counterproductive gaps between market and regulatory approaches to assessing risk.

Third, this approach has the potential to reduce regulatory burden on banks by rationalizing and challenging the measures used by regulators to monitor and respond to bank risk-taking. For example, the reporting burden on insured institutions might be reduced if information currently reported by banks was judged to be unnecessary by market participants.

Although the market can react quickly to events that suggest changes in the solvency of a particular institution, it can also react quickly to events that do not - events such as changes in investor attitudes toward risk in general or the fallout from the distress of an unrelated financial institution. We are mindful, therefore, that care must be taken in designing and implementing market guided approaches in order to realize their considerable promise. We are mindful as well that they are only one part of a balanced approach to monitoring the financial institutions that we insure. As it has in the past, the

effective supervision of these institutions will remain a pillar to the safety and soundness of the industry.

Conclusion

In the coming years, the ability of the financial firms to harness new technologies to meet the demands of households and businesses will be tested, as will the ability of policymakers and regulators to maintain an effective safety net of appropriate scope, while allowing the industry to innovate and compete in the global marketplace. The FDIC recognizes that the deposit insurance system must keep pace with the changes underway while maintaining the bedrock of public confidence we currently enjoy. As we look to the future, we see increasingly sophisticated supervisory approaches, the ability to resolve complex problem situations should they arise, and increasing use of the market to assess risks in the system.

One of the consequences of the elaborate regulatory structure associated with the U.S. financial system is the need to share information, exchange views, and coordinate actions. As the financial services industry grows more complex, this need will grow as well. We look forward to working with other regulators, with the industry, and with policymakers to achieve the balance we need in preserving the safety and soundness of banks while encouraging the evolution of products and practices that will ensure our mutual success in the new century.

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